

Before the
COPYRIGHT ROYALTY BOARD
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Washington, D.C.

In the Matter of)
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Mechanical and Digital Phonorecord)
Delivery Rate Adjustment Proceeding)
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_____)

Docket No. 2006-3 CRB DPRA

WRITTEN DIRECT STATEMENT OF
THE DIGITAL MEDIA ASSOCIATION ("DiMA")
AND ITS MEMBER COMPANIES AOL, LLC;
APPLE COMPUTER, INC.; MUSICNET, INC.; NAPSTER, LLC;
REALNETWORKS, INC.; AND YAHOO!, INC.

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November 30, 2006

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AND ITS MEMBER COMPANIES AOL, LLC;
APPLE COMPUTER, INC.; MUSICNET, INC.; NAPSTER, LLC;
REALNETWORKS, INC.; AND YAHOO!, INC.**

Pursuant to section 351.4 of the rules of the Copyright Royalty Board (“Board”), 37 C.F.R. § 351.4, and the Board’s Order of October 25, 2006, the Digital Media Association (“DiMA”),¹ joined by AOL, LLC; Apple Computer, Inc.; MusicNet, Inc.; Napster, LLC; RealNetworks, Inc.; and Yahoo!, Inc., who have each filed individual notices of participation in this proceeding, submit the following Written Direct Statement (“DiMA’s Direct Statement”) in support of requested rates and terms for the compulsory license to make and distribute phonorecords by means of a digital transmission constituting a digital phonorecord delivery (“DPD”) pursuant to 15 U.S.C. § 115.

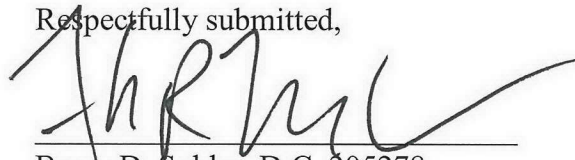
Pursuant to the Copyright Royalty Judges’ “direction” during a telephone conference on November 28, 2006 at 5:30 p.m., and as agreed by the Recording Industry

¹ Established in 1998, DiMA is a national trade organization devoted primarily to the online audio and video industries, and more generally to commercially innovative digital media opportunities.

Association of America, Inc. ("RIAA"), the National Music Publishers' Association, Inc. ("NMPA") and DiMA, DiMA is hereby filing with the Board an original and five copies of the redacted, public version of its written direct statement.. DiMA will file with the Board an unredacted version of its written direct statement once the Copyright Royalty Judges enter a protective order in this proceeding.

DiMA's proposed rates and terms are attached hereto as Exhibit A to this Written Direct Statement.

Respectfully submitted,



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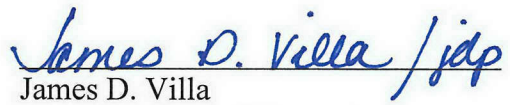
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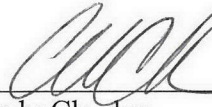
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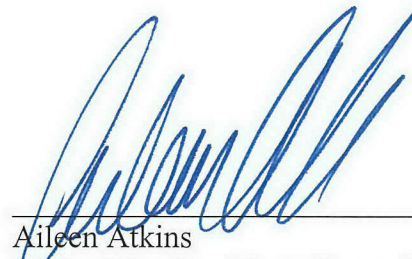
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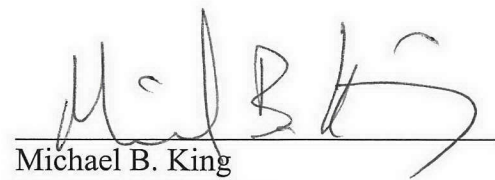


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A

EXHIBIT A:

PROPOSED RATES AND TERMS OF DiMA

Add the following to Chapter III of title 37, Code of Federal Regulations (tentatively numbered part 380 for purposes of reference):

PART 380 – RATES AND TERMS UNDER COMPULSORY LICENSE FOR MAKING AND DISTRIBUTING A DIGITAL PHONORECORD DELIVERY

Sec.

380.1 General.

380.2 Definitions.

380.3 Royalty rates.

380.4 Status of incidental phonorecords.

§ 380.1 General; Scope of license. This part 380 establishes rates and terms of royalty payments for all copies made in the course of making and distributing phonorecords, including by means of digital phonorecord delivery, in accordance with the provisions of 17 U.S.C. 115.

§380.2 Definitions.

(a) *Applicable receipts* means that portion of the money received by the licensee, or licensee's carrier(s), directly attributable to the digital phonorecord delivery in accordance with the provisions of 17 U.S.C. 115, which shall be determined in accordance with Generally Accepted Accounting Principles; provided that, notwithstanding the foregoing, the licensee may pro-rate or allocate money received for purposes of attribution as a percentage of total usage of digital phonorecord deliveries of sound recordings or on any other reasonable basis.

(b) *Digital phonorecord delivery* means a digital phonorecord delivery as defined in 17 U.S.C. 115(d).

(c) *Permanent digital phonorecord delivery* means a digital phonorecord delivery that is distributed in the form of a download that may be retained and played on a permanent basis.

(d) *Limited digital phonorecord delivery* means a digital phonorecord delivery that is distributed in the form of a download that is restricted from being retained and/or played on a permanent basis.

(e) *Licensee* means a person or entity that has obtained a compulsory license under 17 U.S.C. 115 and the implementing regulations therefor to make and distribute phonorecords, including by means of digital phonorecord delivery.

(f) *Licensee's carriers* means the persons or entities, if any, authorized by Licensee to distribute digital phonorecord deliveries to the public.

(g) *Licensed work* means the nondramatic musical work embodied or intended to be embodied in a digital phonorecord delivery made under the compulsory license.

§380.3 Royalty Rates.

(a) For a permanent digital phonorecord delivery, the royalty rate payable shall be 4.1% of applicable receipts.

(b) For a limited digital phonorecord delivery, the royalty rate payable shall be equal to 4% of applicable receipts from said delivery during an accounting period times a fraction, (i) the numerator of which shall be the number of playbacks of all phonorecords of the licensed work and (ii) the denominator of which shall be the total number of playbacks of all phonorecords of all licensed works. For purposes of this definition, a "playback" is any play of greater than 30

seconds by an end user during an accounting period of a phonorecord of the licensed work distributed by limited digital phonorecord delivery.

(c) In any case in which royalties must be allocated to specific musical works under subsection (a) or (b), each unique musical work's share shall be determined on a pro rata basis.

§ 380.4 Status of incidental phonorecords.

A compulsory license under 17 U.S.C. 115 extends to all reproductions necessary to engage in activities covered by the license, including but not limited to:

- (a) the making of reproductions by and for end users;
- (b) reproductions made on servers; and
- (c) incidental reproductions made in the normal course of engaging in such activities, including masters and cached, network, and buffer reproductions.

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Docket No. 2006-3 CRB DPRA

**INTRODUCTORY MEMORANDUM OF
THE DIGITAL MEDIA ASSOCIATION (“DiMA”)
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The digital music revolution is front page news today. DiMA’s member companies are at the forefront of this revolution. Sales of recorded music in traditional

¹ Established in 1998, DiMA is a national trade organization devoted primarily to the online audio and video industries, and more generally to commercially innovative digital media opportunities.

formats such as the CD are declining in an environment where copyrighted works of all kinds are easily copied and distributed over illegal, free Internet file-sharing sites. With a billion music tracks available at no cost to anyone with a computer and Internet access, this is not an easy environment to build a legitimate royalty-paying alternative -- not to speak of investing in, launching, and sustaining an entirely new business model. DiMA's member companies have invested hundreds of millions of dollars to create a new, legitimate marketplace for music, leveraging digital technology and broadband networks and creating innovative business models that deliver value to consumers and copyright owners.

Competition with pirated music is just the first hurdle in the digital marketplace. There is a significant challenge in having to strike a balance between copyright owners' desire to protect their content and not imposing limitations on consumers that discourage them from adopting a service. Royalty payments are substantial. Finding and holding customers who are not used to new technology, new distribution paths, new payment requirements, and new ways to explore and enjoy music present additional difficulties. The market is challenging, brutally competitive, and just getting off the ground. To encourage new entry and continued investment, barriers and costs need to come down.

The Board is being asked to establish -- for the first time, for nascent competitors, in a still-evolving and highly competitive climate -- rates and terms for a critical component of the business for DiMA member companies: the compulsory license to make and distribute phonorecords by means of a digital transmission constituting a digital phonorecord delivery. *See* 15 U.S.C. § 115. The so-called "mechanical" license is the oldest compulsory license in the Copyright Act, dating back to the turn of the century. In

1995, Congress amended the statute to make clear that it covered the making of digital phonorecord deliveries (so-called “DPDs”). *See* The Digital Performance Right In Sound Recording Act of 1995, Pub. L. 104-39, 109 Stat. 336 (1995) (“DPRA”).

It is important to understand what the section 115 compulsory license is and what it is not. The license provides the right to use one musical work in exchange for complying with extensive terms and conditions through the Copyright Office. The license is not a “blanket license,” which would allow the user unlimited access to a repertory of works in a catalog. In the marketplace, the statutory rate provides a benchmark which represents the value of the copyright contributed by copyright owners or their agents to the aggregated product that is pre-recorded music. For DiMA members, the statutory rate is the royalty amount demanded and obtained in the agreements entered into to bring these works to the consuming public. The system for direct licensing is cumbersome and virtually unworkable for modern requests to use entire catalogs of songs in the context of a digital music service. When this proceeding is concluded, many DiMA member companies will need to undertake the difficult and expensive task of administering and making payments to thousands of copyright owners.

The 1995 DPRA confirmed that section 801 of the Copyright Act, 17 U.S.C. § 801(b)(1), provides the standard for setting rates and terms for the making of DPDs. *See* DPRA, 109 Stat. at 341. Subsequent and repeated amendments to the Copyright Act, even adopting new ratesetting standards and processes, have kept the original standard for evaluating and setting the royalties under section 115 intact. *See* Title 117 Technical Amendments, Pub. L. 105-80, 111 Stat. 1529 (1997) (no change to mechanical royalty rate setting standard); Digital Millennium Copyright Act, Pub. L. 105-304, 112 Stat. 2860

(1998) (same); Small Webcaster Settlement Act of 2002, Pub. L. 107-321, 116 Stat. 2780 (2002) (same); Copyright Royalty and Distribution Reform Act of 2004, Pub. L. 108-419, 118 Stat. 2341 (2004) (implementing wholesale changes to the rate setting process but not changing the standard to be applied in setting mechanical rates); Copyright Royalty Judges Program Technical Corrections Act, Pub. L. 109-303, 120 Stat. 1478 (2006) (amending certain processes carried out by the Copyright Royalty Judges, but not changing standard for mechanical royalty rate setting).

The courts and the Copyright Office have made clear that the section 801(b)(1) standard is based on several policy objectives and not a simple marketplace standard. *See Recording Industry Assoc. of Am. v. Copyright Royalty Tribunal*, 662 F.2d 1, 9 (D.C. Cir. 1981) (rate is to be calculated to achieve statutory objectives); *Recording Industry Assoc. of Am. v. Librarian Of Congress*, 176 F.3d 528, 533 (D.C. Cir. 1999) (“The statute does not use the term ‘market rates,’ nor does it require that the term ‘reasonable rates,’ be defined as market rates”). *See also Determination of Reasonable Rates and Terms for the Digital Performance of Sound Recordings*, 63 Fed. Reg. 25394, 25399 (May 8, 1998) (the standard for setting rates under section 801(b) “is not fair market value”). The Board is directed to evaluate a range of evidence with reference to statutory objectives intended to promote the availability of musical works to the public, recognize the costs and risks involved in making that possible, and avoid undue disruption in the market. *See Recording Industry Assoc. of Am.*, 662 F.2d at 6.

OVERVIEW OF DiMA’S WRITTEN DIRECT STATEMENT

DiMA’s Written Direct Statement is supported by Written Testimony from the following individuals:

1. Tab 1. Jonathan Potter, Executive Director, DiMA, provides background and history of the digital music industry, the legal and policy uncertainties DiMA has attempted to resolve for its member companies, and the benefits DiMA member companies offer to content owners. Mr. Potter's testimony explains that the digital music industry represents an opportunity for copyright owners and the possibility of new value for content creators and users of copyrighted works.

2. Tab 2. Kyle Johnson, Vice President, AOL, LLC, describes that company's entry into the digital subscription music business and its experience, first outsourcing to MusicNet, then acquiring a stand-alone service to offer, and finally its decision to exit this market. AOL sought to provide music offerings that appeal to the broad range of customers and potential customers in the marketplace. Having experimented with different business models, AOL found the business could not achieve expectations due to a variety of factors, in particular the difficulty of attracting sufficient customers in the current environment.

3. Tab 3. Eddy Cue, Global Vice President, iTunes at Apple Computer, Inc., offers the experience of the market-leading iTunes Store, which has revolutionized the music industry by putting consumers first and offering a new and innovative environment for consumers to explore, purchase, organize, and listen to music. Apple has revitalized the music business in the face of the dying CD format, turning-on entire new generations to music, and bringing others back into the fold.

4. Tab 4. Alan McGlade, Chief Executive Officer, MusicNet, Inc., explains the unique business model entailed in subscription music offerings as a wholesale provider to distributors of content. MusicNet provides the backbone and platform that

enables massive scale and scope efficiencies to distributors who in turn focus on marketing to consumers. Mr. McGlade will explain the costs and risks shouldered by the business and the benefit received by songwriters, distributors and consumers in return.

5. Tab 5. Laura Goldberg, Chief Operating Officer, Napster, Inc., provides an overview of Napster's diverse service offerings, which have grown out of an investment of tens of millions of dollars in subscription music. Ms. Goldberg will describe how Napster is constantly innovating to reach new users, making music more accessible, adding value for existing customers, and bringing new features to the digital music market.

6. Tab 6. Tim Quirk, Vice President of Music Content and Programming, RealNetworks, Inc., offers unique insight into the digital music environment as a published songwriter, accomplished musician and bandleader, engineer, and executive who is passionate about the benefits subscription services can provide to content creators and consumers alike. Turning part-time or infrequent purchasers or grazers into music fanatics is Real Networks' focus.

The written testimony supporting DiMA's Written Direct Statement explains fully how DiMA member companies invest and innovate to maximize the availability of creative works to the public. By offering new ways for consumers to search for, select, organize, experience, and enjoy music in a manner that also compensates copyright owners, DiMA members are helping to create economic opportunity in an environment that has been radically altered -- and is constantly threatened -- by rampant copyright piracy. At the same time, the possibilities of a thriving digital marketplace are clearly present, so long as continued investment is encouraged.

The written testimony also explains how DiMA member companies bring more music to more consumers and encourage more spending on a wider range of music than was ever possible before. Sales of music in the traditional retail world are declining. Most retail environments offer only the top hits, or a declining selection. By making the widest possible catalogs of legal, royalty-generating digital music easy to find, easy to organize, explore, and share, and by making it possible to enjoy music in new environments and on new platforms, DiMA member companies create value for songwriters and publishers. By weaning consumers away from pirated music and encouraging them to explore and buy the entire range of works, not just the top 10 or top 100 songs, DiMA member companies unlock value for content creators. Music that would never make it to retail shelves sells on DiMA member platforms. Songwriters and publishers earn money where they otherwise would lose access to the market and forgo revenue. This is a significant and meaningful contribution that must be recognized in this proceeding.

As the written testimony demonstrates, however, none of these contributions are easy or inexpensive. DiMA member companies have made hundreds of millions of dollars of investments and created new business models from the ground up. These investments have resulted in more music being more accessible to more consumers than ever before. DiMA member companies continue to devote considerable resources to develop and market their services to consumers and to keep customers coming back to buy monthly subscriptions or make it their habit to buy digital tracks for permanent download instead of frequenting pirate music networks. Songwriters and publishers benefit from all of this and invest nothing to make it work.

Meanwhile, the written testimony demonstrates that, while digital distribution may lower some traditional music distribution costs, it creates others. While DiMA members may not all need a warehouse for inventory, they need to spend money on marketing new business models, bandwidth, engineering and software development, and credit card fees. Indeed, the copyright licensing environment remains unsettled and evolving, with the same copyright owners clamoring for multiple payments for the public performance and reproduction and distribution of their works as a result of the same activity. In light of these challenges, it takes creativity, innovation, investment, and continuous effort to make new business models work.

As the testimony makes clear, DiMA members compete in difficult economic conditions where their major competitor is a free and ubiquitous catalog of music available on illegal sites and services. As a result of rampant Internet piracy, consumers have quickly come to expect music to be cheap and accessible everywhere. Music license fees and restrictions imposed by rights management controls throw cold water on those expectations and make it harder to convince customers to buy. For all of these reasons, the success of DiMA member companies to date is remarkable but fragile. Under these conditions, a “fair return” depends on the alternative -- the absence of any returns in a market completely overwhelmed with digital piracy.

Fundamentally, this fragile marketplace is showing signs of promise, but it cannot be saddled with additional, excessive costs. DiMA member companies are operating under severe economic constraints, which will get worse if they are forced to pay unreasonable royalties. Therefore, the Board should be careful not to impose a royalty that kills the proverbial goose and deprives songwriters and publishers of their golden

egg. There are tremendous hurdles to be overcome in establishing and growing this market in the next five years. Setting a rate too high, or imposing industry-wide minimum fees that restrict usage and drive consumers to pirated music sites, would have a devastating effect on DiMA companies as well as songwriters.

Analyzing the evidence provided by DiMA member companies under the statutory factors, DiMA submits, at Tab 7, the expert opinion of Margaret Guerin-Calvert, an economist and President of Competition Policy Associates. Ms. Guerin-Calvert reviews changes in the marketplace for mechanical reproductions and distributions since the last ratesetting proceeding under section 115, analyzes the information in light of the section 801(b)(1) statutory factors, and recommends a rate proposal that would satisfy those objectives.

Ms. Guerin-Calvert finds that the digital music industry represents a fundamental and revolutionary change in the mode of delivering music content. Substantial investments and innovation, undertaken at considerable risk, have been required to develop market-based mechanisms for delivering and marketing content to the ultimate consumer. A wide range of different business models have attempted to meet consumer demands and the industry is still evolving in structure and format. There is no one long-term clear technology of choice. The industry continues to evolve with new partnerships and technologies, and with price sensitivity at the consumer level. As a general matter, profitability is still volatile and uncertain given consumer choices and the need to adapt to a variety of industry pressures, including piracy and the widespread availability of non-royalty bearing music. In particular, the availability of unauthorized “pirated” music represents major challenges in terms of price sensitivity and competition.

Ms. Guerin-Calvert notes that, despite these obstacles, DiMA member companies have invested substantially and expanded considerably the depth and breadth of catalogue offerings in the marketplace and the range of offerings from copyright owners. Growth in the digital pie has tremendous spillover benefits for copyright holders who will gain in the legitimate market sale of their music, and particularly to expand the scale and the scope of offerings relative to traditional CDs.

Still, she concludes in her report that the challenges facing the industry are significant and require careful consideration in formulating an appropriate royalty. There is no basis for assessing higher royalties on these users today than what was imposed on the recording industry in 1981. Any royalty must be sufficiently flexible to account for a variety of business models, uncertainties and financial risks associated with the ongoing evolution and development of the industry, and the need to continually invest substantial monies to market digital music. A reasonable royalty consistent with the statutory objectives must take into account the high level of price sensitivity of consumers for digital music in its various forms, while continuing to provide the relevant incentives for copyright owners and other participants to develop and expand the creative works available to consumers, and compensate fairly on an ongoing basis.

In her analysis, Ms. Guerin-Calvert takes into consideration the elements evaluated when mechanical rates were previously set under the statutory objectives in 1980 and accounts for fundamental differences that exist in industry conditions between the two periods. As a result, she concludes that a reasonable rate should be based on a percentage of revenues and not a per-unit basis. A percentage of revenue structure provides a mechanism to allow for copyright users and owners to share in the actual gains

from expansion of digital sales, while allowing for a cost structure that promotes such expansion and financial viability. A percentage of revenue approach is also a preferred approach for the longer term duration of the compulsory rate under consideration in this proceeding because it effectively adjusts over time.

To meet the statutory objectives, Ms. Guerin-Calvert further concludes that a reasonable rate would be at the low end of a range between 4% to 6% of applicable retail revenues. Importantly, she concludes that the risks of setting a rate too high far outweigh any risk of setting a lower rate at this stage of industry development. Differences between permanent and conditional downloads justify a differential in their royalty rates, but not one inconsistent with the overall importance of rates at the low end of the range of reasonableness. Ms. Guerin-Calvert finds that a minimum fee would be inconsistent with the statutory objectives and unduly disruptive, reducing the output of creative works without providing any real benefit to copyright owners. She concludes that DiMA's proposed rates are consistent with her evaluation.

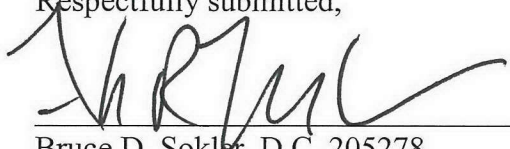
CONCLUSION

As set forth in Exhibit A, and consistent with its economic expert's analysis of the marketplace and her report, DiMA proposes a base rate of 4.1% of applicable revenues for permanent digital phonorecord deliveries ("DPDs") and 4% of applicable revenues for limited ("conditional" or "tethered") DPDs with no minimum fee for either use. All copies made in the course of making and distributing the digital phonorecord delivery to the consumer would be licensed at the applicable rate.

These rates and terms are intended to satisfy the statutory objectives and ensure the development of a marketplace alternative to pirated musical works so that creators

and consumers both benefit. The evidence will show that now is not the time and this is not the market for higher rates, minimum fees, or more excessive regulatory intervention, which will be massively disruptive and cause further exit from the legitimate market to the detriment of consumers and content creators alike.

Respectfully submitted,

A handwritten signature in black ink, appearing to read 'B. Sokler', written over a horizontal line.

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CERTIFICATE OF SERVICE

I, Michael T. Haas, hereby certify that by agreement of the parties, on this 30th day of November, 2006, that I caused true and correct copies of the public version (without exhibits) of the foregoing Written Direct Statement of the Digital Media Association; AOL, LLC; Apple Computer, Inc.; MusicNet, Inc.; Napster, LLC; RealNetworks, Inc.; and Yahoo!, Inc., to be served upon each of the individuals listed below via electronic mail. I further certify that any party identified with an ("****") accompanying their names also received one true and correct copy of the unredacted/restricted version of the aforementioned Written Direct Statement (with exhibits).

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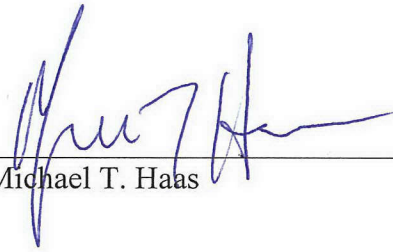
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